

***UNDERSTANDING THE PROCESS OF ECONOMIC
CHANGE, BY DOUGLAS NORTH.
PRINCETON: PRINCETON UNIVERSITY PRESS, 2005.
187 pp.***

Reviewed by
Andreea IACOBUȚĂ*, Iolanda VODĂ**

The famous American economist, Douglas North is a representative of the New Institutional Economics (NIE). He is, at the same time, a pioneer as he has identified and promoted a new direction of research within NIE which is focused on the role of the institutional framework in the process of formation and becoming of modern economies. By stating and bringing consistent and consequent arguments for the fact that „*the process of economic growth matters*”, North gives a foreword to the theory of economic dynamics in its institutional version. His ideas, exposed in two fundamental books, the former being published in 1981 (*Structure and Change in Economic History*) and the latter in 1990 (*Institutions, Institutional Change and Economic Performance*) have inspired the contributions and achievements in the field of institutional economics and acknowledged him in the academic world. In 1993, he was awarded the Nobel Prize in economics “*for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change*”.

The paper *Understanding the Process of Economic Change*, published in 2005 is considered by the author himself as a synthesis, “*a brief review of my early*

* Andreea IacobuȚă ,PhD, Assistant Lecturer, Faculty of Economics and Business Administration “Alexandru Ioan Cuza” University of Iași

** Iolanda Vodă, PhD Student, Faculty of Economics and Business Administration “Alexandru Ioan Cuza” University of Iași

work” (p. vii), and an award for his efforts to give an institutionalist basis to the understanding of economic dynamics. Moreover, we believe that the book is a new inspired and welcomed contribution to the generous literature that approaches the NIE issue.

The book approaches the issue of dynamics of economic growth and the author proves that economic performances are mostly determined by the type and quality of the institutions that sustain the markets. North believes that the understanding of the relationship between economic dynamics and institutional dynamics will allow a better shaping of institutions that sustain economic performance. The purpose is to avoid failure that people faced and reduce the difference of development in the world economies.

The relationship between economic dynamics and institutional dynamics is signalled from the first page of the work where D. North mentions that economic change is a function of „1. *the quantity and quality of human beings*; 2. *the stock of human knowledge particularly as applied to the human command over nature*; 3. *the institutional framework that defines the deliberate incentive structure of a society*” (p. 1). The three factors are interrelated and contribute to the process of economic change which is meaningless in itself. Therefore, according to North, “*a complete theory of economic change would therefore integrate theories of demographic, stock of knowledge, and institutional change*” (*Idem*).

This is the reason why the work aims at an interdisciplinary approach which is required by the nature of the studied process itself that involves, beyond the economic dimension, man and human behaviour, institutions, experience, acquired values, the demographical, historical and social dimension, etc.

North justifies his concern for the analysis of the processes of economic and institutional change in a resuming sentence: “*the world we live in is non-ergodic – a world of continuous novel change; and comprehending the world that is evolving entails new theory, or at least modification of that we which possess*” (p. 16).

To sum up, this quotation refers to two things:

Firstly, economics, institutions, the world in its whole are moving. Consequently they have to be analysed in their dynamics.

Secondly, such an analysis requires the restructuring of what Ronald Coase calls “an economics taught in the classroom”, i.e. the neoclassical paradigm and its methodological hypotheses and principles which are inadequate to human nature and the real world. By returning to this aspect of the book and detailing it, North

has in view three fundamental deficiencies of neoclassical economics, that is, "*it is frictionless, it is static and it does not take into account human intentionality*" (p. 65).

North replies that the entire NIE proposes a "controversial" approach by integrating time in the analysis and by putting human activity under the sign of intentionality (p. 66–80).

Controversies pertain to the imperfection of the world and the opportunism in the individuals' behaviour. This is where institutions intervene. They are called "*to structure human interaction by providing an incentive structure to guide human behavior*" (p. 66). At the same time, the stimuli are identically perceived by all individuals. Consequently, the rules are summoned to have an influence not on homogenizing behaviours, by solving controversies, but rather on attenuating opportunism.

Secondly, economic activity and dynamics are subject to the passage of time. Not to include the time variable in the analysis means taking distance from human nature and the real world as long as "*(1) we cannot know today what we will learn tomorrow which will shape out tomorrow's actions and (2) it is a non-ergodic world*" (p. 69), according to North. The compensation for the limited (ontological and epistemological) rationality of individuals corresponds to learning and imitation.

Finally, human action bears the mark of intentionality. Man acts based on anticipations and he uses strategies to fulfil his goals. Human intentionality is not only a decisive factor in Northian analysis, but also a product of „social learning“, explaining the capacity of economics to adjust to changing circumstances.

Although intentionality is the main attribute that describes human activity, social engineering is not generally accepted to establish order. In order to bring arguments in the matter, North gives the example of the former Soviet Union and asserts that "*the rise and fall of the Soviet Union is a sobering exploration of the human endeavor to deliberately craft society*" (p. 8).

Thus North draws from Hayek's critical rationalism by means of spontaneous order guided by the „invisible hand“. North also clearly opts for order and his initial discourse remains a principle when he accepts the variant of authority (the deliberately built order) in the context of an unsure environment which is a definite source of disorder that cannot always be consensually dealt with. He does not clearly opt for any type of order but he implies that both types

are justified in history. Hence, North, as well as the other institutionalists does not believe in absolute liberalism, he does not exclusively accept the *laissez-faire* way, as he is convinced that modern institutions do not automatically lead to balance. In this context, he sees a deliberate process in economic change that automatically obliges to institutional change.

To relate economic change to institutional change, North uses the concept of adapting efficiency (firstly introduced in the work *Institutions, Institutional Change and Economic Performance*). This aims at the institutional matrix that proves its adapting features by flexibly giving solutions to economic change. In other words, societies are permanently searching for ways to solve the problems that occur in time. This is possible due to the stimuli given by institutional structure. In Northian understanding, adapting efficiency is possible when four conditions are met: “*the establishment of credible bounds on the behavior of political officials; successful constitutions which limit the stakes of politics in part by assigning citizen rights and placing other limits on government decision making; property and personal rights must be well defined so that it is evident to citizens when these rights are being transgressed; the state must provide credible commitments to respect these rights, thus providing protection against opportunism and expropriation by public officials*” (p. 108).

Thus delimited, the aims of adapting efficiency may, on the one hand, be fulfilled only in the long term and, on the other hand, they send to the institutional matrix which includes in its whole, both formal and informal institutions, as well as their interaction. North assesses institutional dynamics to the way of interaction between formal and informal institutions. All his works imply that there is a strong interdependence between institutions. Both formal (property, free market, currency, etc.) and informal rules (customary laws, social conventions, cultural traits of behaviour, heritable values, etc.) are variables that generate growth and economic performance. This idea is present in *Understanding the Process of Economic Change* as well, where he repeats his conviction that “*there is an intimate relationship between belief systems (informal rules – n.n.) and the institutional framework (formal rules – n.n.)*” (p. 49), highlighting the power of influence of informal norms. These are nothing but “mental constructs” by means of which individuals perceive and interpret reality. If formal institutions may be changed „over night” by authorities, faiths, norms, values, etc. are slowly changing and they tend to be very resistant to change.

Due to the fact that human action and thought are structured by society rules in a process of selection of the experience of generations, the movement of institutional framework naturally has a certain inertial, incremental character that, in North's opinion, reflects "*the constraints that the past imposes on the present and the future*" (p. 49). In other words, there is a phenomenon called path dependence that synthetically refers to the dependence on the past and behavioural inertia. Consequently, the changes in the institutional matrix are determined by the existing institutions which, in their turn, narrow the present and future options. This is not to be understood in a determinist way of an unavoidable situation in which the past accurately predicts and imposes the future. The past has the value of a model to be followed or not that invites to learning, to what one is allowed to do or not. North seems to accept the simple statement according to which „a person, who does not know history, is likely to repeat it". A glance at the past helps us see the path to follow in order not to make the same mistakes again or points us the „source of the stoppage" on the path of evolution so as to be eliminated. However, it is up to us to find the path to follow for institutional change to have the expected effect, i.e. to induce economic performance.

In North's opinion, despite people's basic universal structure of values, there is a large variation with respect to economic performance. This feature reveals the importance of the way in which this structure of values is transposed, by means of culture, in structures that succeed or fail. He gives the example of American economy that benefited from British cultural inheritance: "*The heritage of British institutions created a favorable milieu for the development of the institutions of impersonal exchange which were the foundation of the long-term economic growth of the American economy*" (p. 112).

Thus, path dependence forces us to accept that cultural inheritance has a word to say and influences the success of the chosen solution. Consequently, there is no optimal, unique institutional variant which can be applied anywhere and anytime to guarantee economic performance. The institutional „import" (transplanting institutions that have proven the capacity to create wealth in developed societies) must take into consideration what is specific to the „importer".

Departing from such a field, North indicated the steps of a path to follow in a chapter significantly entitled "Getting It Right and Getting It Wrong". There is a thin line between succeeding and failing. In North's words, succeeding means that "*1.the implications of the novel changes would be understood with respect to the*

effects, on the three fundamental sources of change – demography, the stock of knowledge, and institutions – and the resultant new interaction among them; 2. this new knowledge would be incorporated in the belief systems of those in a position to modify the institutional matrix; 3. the formal rules, the informal constraints, and the enforcement characteristics would be altered accordingly and would produce the desired changes in societal performance” (p. 116–117).

Once the steps to follow have been established to reach institutional and economic performances, North gives a new example to explain what to succeed and to fail mean. The model of success alludes to “The Rise of the Western World“, and failure to “The Rise and Fall of the Soviet Union“, justified by the lack of adapting efficiency and a flexible institutional structure.

The last chapter of the book, “Where Are We Going?” brings back into discussion human nature, intentionality and individual behaviour in taking a decision. To conclude, North mentions that the economists’ efforts must be focused on “*the understanding of the sources of human decision making*”, in the context of permanent uncertainty in a non-ergodic world.

Beyond its ideal original and dense substance, the book deserves to be read because the proposed theme is in the pipeline. Here, we have two aspects in view: the former corresponds to the priorities of human society which (still!) undergoes a process of institutional change towards a genuine market economy; the latter could give solutions for the present world economic crisis.

Firstly, with respect to Romania, although progress has been made in building institutions that promote the idea of a free market, the quality of the institutional environment is still sensible and remains a challenge for what Daniel Dăianu called “the bet with development”. By employing the terminology and explanations given by D. North, we may say that *institutional frailty* which is mentioned by a series of specialists in transition may be asserted to a high level of path dependence and behavioural inertia that damages the process of learning, imitation and experience. Therefore, after two decades of transition, Romania is still low ranked among the EU countries, with lower results than other post-socialist countries in the charts for institutional quality and economic competition.

Secondly, the world is changing. The present world crisis obliges to a reconsideration of both theory and economic policy and the old-fashioned „rules of the game” which do not seem to offer proper solutions to the new realities any more. We mainly refer to the fact that the crisis affecting the economy of the

United States clearly proves that an economic model and mechanism may have the stock market as its main piece of the puzzle and speculation on the field of nominal economy as a growth generating factor which involves too greater risks and should not be followed. From the point of view of economic doctrine and policy, the present moment reinvents Keynes and Samuelson. Ergo the perimeter of US economy, one of the most liberal in the world, calls for the state and its institutions, especially the financial ones. But trust is a formal institution that significantly contributes to the efficient running of the market and democracy. Consequently, there is a lack of consensus between formal and informal rules which, as North stated, is one of the essential conditions for the process of institutional change to succeed.

The above mentioned aspects and many others in the book which have not been mentioned here are sufficient arguments for reading this book. Transgressing the borders of economics, the book offers a different perspective which cannot be found in the standard textbooks of economic theory on the way to perceive and interpret the world we live in and its evolution. It is impressive for the economist reader – although the book does not entirely address him – due to the richness of ideas or the interdisciplinary vision and especially due to the pleading for such a solution to the problems of economic development that many of the world countries are facing.

